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Construction Industry Update Newsletter

Surety Outlook for 2011

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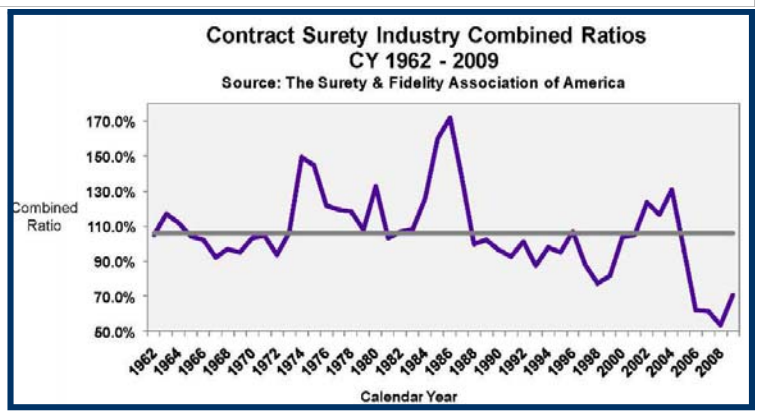
What a difference a few years make…. To understand the surety market outlook for 2011 and beyond, it is important to take a look back, assess the trends, and then apply some wisdom to successfully forge ahead into the future!

Surety in the Early 1990s

- Robust Economy
- Excess Surety Capacity
- Low Premiums
- Relaxed Underwriting and Indemnity
- Expansion of Commercial Surety

The surety industry has a long history of losses and profitability. Exhibit A shows a 48-year tracking of the contract surety combined ratio as incurred by surety companies. The straight line is the 48-year average, which is about a 106.1% combined ratio. In 2009, the combined ratio for contract surety was 70.8%. Combined ratio is the sum of the direct losses and the total loss adjustment, underwriting and administrative expenses as a percentage of earned premium (see illustration above).



As illustrated, throughout the 1990s, as the economy boomed and interest rates dropped, surety was a profitable industry. The strong economy kept contractors busy and failures low. Excess capacity built up in the surety market as a number of new surety companies entered the market. As a result of competitive practices, bond premiums were artificially low. Many companies relaxed underwriting standards as they competed for market share. Commercial surety for non-construction guarantees also expanded rapidly into new areas – creating many new surety products with unknown risks.

Surety in the Early 2000s

- Bouncing Economy
- Significant Commercial Losses
- Heavy Contract Losses
- Increased Rate of Failures
- Surety Consolidations and Market Share

Beginning in 2000, after more than a dozen years of profitability, the surety industry began to experience losses as the economy began to falter. Commercial surety was especially hard hit in 2001 and 2002 from the effects of a series of high-profile corporate failures, and by 2002 contract surety losses soared.

Surety 2011 *(continued on page 2)*

In this issue…

Surety 2011 *(continued from page 1)*

In 2002, many large general contractor defaults hit the industry, followed by the failure of many subcontractors. According to BizMiner, of 853,372 building, heavy/highway and specialty trade contractors operating in 2002, only 610,357 were still in business by 2004 – a 28.5% failure rate. Of the 850,029 companies in business in 2004, 649,602 were still in business in January 2006, an improved 23.6% failure rate. But the economy rallied in 2005-2007. Of the 1,155,245 companies operating in 2006, 919,848 were still in business in 2008 – a 20.4% failure rate. The decline in failures were directly attributed to a rebounding robust construction economy, disciplined underwriting, better job selection by contractors and improved profit margins.

Then in 2009, failure rates begin to increase again. A few of the key factors for the turn have been reduced construction starts, increased competition, tightening credit terms, inflation, new entrants into public construction, the weak U.S. dollar and a downward pressure on profit margins. While many of today's contractors are better businesspeople – with more sophisticated systems for estimating, monitoring, and constructing projects – and sureties have implemented tools to better judge the credit and performance worthiness of their clients – the economy is still the primary driver of a contractor's success.

The latest figures from BizMiner confirm the economic trend effects on contractors. Of the 1,424,124 companies operating in 2007, only 969,937 were still in business in December 2009—a 31.9% failure rate. The failure rate for startups was even higher—37.9%.

According to The Surety & Fidelity Association of America's "Twelve-Year Experience Summaries (1997-2008) Surety Countrywide" (Exhibit B), almost $190 million in contract surety claims were incurred in 2008, hit a low of 6.1% loss ratio. This is a dramatic drop from the $1 billion paid in 2005, a 43.8% loss ratio. Sureties have paid about $10.5 billion since 1994 on contractor defaults; half of that was paid from 2002-05. When published, the 2009 and 2010 results for the surety industry's premium to loss ratio are expected to trend back up in the coming years as contractor failures rise.

Recent loss ratios for contract surety (Premium to Losses):

- 1990: 30.4%
- 2000: 45.4%
- 2001: 49.8%
- 2002: 67.0%

Surety 2011 *(Continued on page 3)*

2010-11 Risk Management Series

- **Workers Compensation 101 and PART**
  Friday, December 17, 2010
  Registration: 7:30 am
  Program: 8:00 am - 10:30 am
- **OSHA 300 and Safety Issues in the Office**
  Friday, January 14, 2011
  Registration: 7:30 am
  Program: 8:00 am - 10:30 am
- **Measuring Safety Performance for Your Bottom Line**
  Friday, February 11, 2011
  Registration: 7:30 am
  Program: 8:00 am - 10:30 am
- **Sexual Harassment Prevention Training**
  Friday, March 4, 2011
  Registration: 7:30 am
  Program: 8:00 am - 10:30 am

All training sessions available to our clients
*** Reserve early / seating is limited!**

Register for upcoming seminars

Contact **Darcee Nichols** at **dnichols@cavignac.com** or call **619-744-0596**

*** NOTE:** **Due to the popularity of our seminars and limited space available, we regret we cannot provide refunds or credits with less than 72 hours advance notice of cancellation.**

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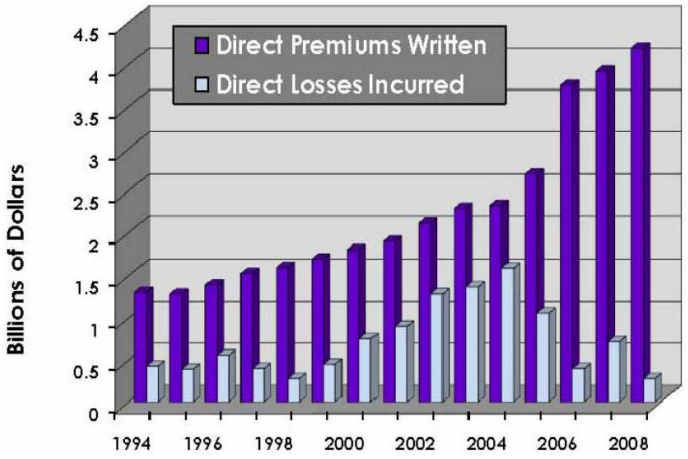


Source: The Surety & Fidelity Association of America
"Twelve-Year Experience Summaries (1997-2008) Surety Countrywide"

Exhibit B

Surety 2011 *(continued from page 2)*

- 2003: 64.8%
- 2004: 73.0%
- 2005: 43.8%
- 2006: 11.0%
- 2007: 13.4%
- 2008: 6.1%

See Exhibit B

There are more than 150 insurance groups writing surety bonds. Eleven of the Top 15 writers of all U.S. surety have merged or left the market since 1994. In 1990, the Top 10 wrote nearly half of total surety. By 2008, the Top 10 wrote two-thirds of all U.S. surety and the Top 5 companies wrote 55% of all U.S. surety. In the surety industry's case, consolidation has been positive. The sureties remaining are stronger and more disciplined.

Most recently Liberty Mutual Surety acquired Ohio Casualty and Safeco, which made Liberty Mutual the second largest surety company. Hanover Surety moved west and acquired ICW Surety Group. XL Surety has replanted their flag from a quick exit a few years back. And, a number of smaller surety markets have entered the bond business, and the more established smaller carriers have redefined their approach to the surety business. This is good news for small to medium-sized contractors seeking bonding capacity.

See Exhibit C

Surety Outlook for 2011 & Beyond

- Increase a risk for Owners, Contractors and Sureties caused by economy
- Tighten underwriting, project analysis & risk management
- Stable Surety Capacity
- Return to growth in nonresidential construction expected in 2011
- More competition, fewer projects
- Tightened operations for contractors
- Increase in contractor failures
- Marginal contractors will have difficulty obtaining bonding
- Surety bonding is available for good contractors

The current weakened state of the economy is expected to increase risk for owners, their contractors, and the sureties that bond them. Surety remains at its core a credit product and is subject to substantial volatility over time. Following significant losses earlier in the decade, the surety industry "*returned to the basics*" of sound underwriting, exposure management, and project analysis. These actions stabilized capacity by restoring profitability and preserving the capital necessary for sureties to stand the test of time. Moreover, the excellent results posted by the surety industry in 2005 - 2008 positioned companies to ride out the current economic downturn.

With the slowdown of residential construction in 2008 then in nonresidential construction in late 2009, and now with small backlogs, sureties don't expect to see growth return until late 2011 or longer, despite the

Surety 2011 *(Continued on page 4)*

Surety & Fidelity Association of America
Top 15 Surety Writers
1994 vs 2009

1994			2009		
	Surety	($millions) Premium		Surety	($millions) Premium
1	~~Reliance~~ → Travelers	147.1	1	Travelers Bond	924.2
2	~~USF&G~~ → ~~St. Paul~~ → Travelers	144.1	2	Liberty Mutual Insurance Group	723.2
3	~~F&D~~ → Zurich	142.5	3	Zurich Insurance Group	486.8
4	~~St Paul Group~~ → Travelers	140.9	4	CNA Insurance Group	406.1
5	~~AIG~~ → ~~AIU Holdings~~ → Chartis	111.5	5	Chubb & Son Inc. Group	277.0
6	~~Aetna~~ → Travelers	106.6	6	Hartford Fire & Casualty Group	181.0
7	~~Continental~~ → CNA	100.7	7	HCC Surety Group	165.2
8	Fireman's Fund → Out of surety	97.3	8	International Fidelity Insurance Co.	147.1
9	CNA Insurance Companies	92.8	9	ACE Ltd. Group	109.0
10	Safeco → Liberty Mutual	88.9	10	The Hanover Insurance Group*	100.1
11	Chubb	77.7	11	Great American Insurance Companies	96.2
12	Hartford	74.0	12	NAS Surety Group	93.9
13	~~Amwest~~ → Gone	70.2	13	Lexon/BondSafeguard Insurance Cos.	86.7
14	~~Capsure~~ → CNA	55.3	14	Arch Capital Group	78.6
15	~~CIGNA Group~~ → ACE	49.7	15	Chartis Group	77.3

Companies that are gone in **RED**
Companies that merged or were sold are in **BLUE**
Companies that merger or were sold a second time are in **GREEN**
* **Acquired ICW Surety Group**

Exhibit C

Surety 2011 *(continued from page 3)*

federal economic stimulus package. Anticipating the completion of public works projects and continued limited public funding for new projects, it is expected the construction market will remain competitive at all levels – from the very small to jumbo contractors. The very best contractors should have no trouble obtaining bonds, while the marginal contractors will have difficulty. Although some will not survive, contractors need to tighten their operations to emerge through these difficult economic conditions.

Sureties are looking more closely at onerous contract terms and conditions such as consequential damages, delay damages, hold-harmless obligations, efficiency guarantees, and extended maintenance and warrantee requirements. Contractors may experience changes in their bonding program due to more disciplined underwriting factors previously discussed.

Be Prepared for Change

Small contractors may encounter challenges in meeting the more meticulous underwriting. Several surety companies have programs for emerging contractors, while other companies specialize in the small contractor market. The U.S. Small Business Administration Surety Bond Guarantee Program may become a popular option for those unable to obtain bonds by traditional means. New and emerging contractors will need to provide well thought-out business plans, CPA-prepared financial statements and higher quality information on their company in a more frequent and timelier manner than in the past.

All contractors should accurately assess their own capabilities. It is important to look at operating profitability and maintain a history of completing contracts profitability. Complete, accurate and timely job costing and financial reporting is mandatory in today's environment.

Communicate good and bad news real time to your surety business partners. The most important thing a contractor can do is keep the surety informed when problems arise. If approached in a proactive manner, many surety companies will work with the contractor through a problem.

Construction is cyclical and contractors should prepare for the pent-up demand that will build during a recession. While contractors must retrench during these lean times, they also need to protect their core resources and be ready to bid work when the economy rebounds. The surety is a critical partner through good times and bad and can help owners and contractors manage the changing economic climate.

- Conserve capital – stay liquid. "Cash is King".
- Aggressively Bill and Collect (minimize Underbillings and Retentions)
- Procure materials and lock in prices whenever possible.
- Have the right size of a bank line of credit available to support the company's business plan. Have a backup bank lined up in the event your bank reduces – or does not renew – your credit line, or becomes financially unstable.

Surety 2011 *(Continued on page 5)*

Surety 2011 *(Continued from page 4)*

- Don't "buy" a job to keep employees busy – adjust overhead and maintain profit margins. Bid the job, not the competition.
- Bond subcontractors. Requiring bonds on subs is an effective way for contractors to manage risk on projects. Follow your Subcontractor bonding policies, especially in today's economic climate. Subs should be bonded when:
  - They represent a key trade to the project or a significant portion of the work;
  - They are the sole source for anything; or
  - When the contractor is unfamiliar with the subcontractor.
- Qualify the sureties you receive subcontract bonds from by contacting your state insurance department.
- Do what you do best. "Stick to your Knitting"
- Understand your contract and require effective and equitable contract language.
- Read the bond forms and watch for onerous terms.
- Protect your top talent, who will manage projects well no matter what the market conditions are and who will be essential when the economy recovers.
- Work with a construction-oriented CPA, banker and attorney.

In times of economic uncertainty or difficulty, a well-developed surety relationship is essential. The contractor, professional surety bond producer, and surety company underwriter are the key players on this invaluable team. There are three basic stages to a long-term surety relationship:

- Meeting. At least once a year contractors should meet with the surety underwriter and surety bond producer. The company's CPA, bankers and attorney should attend.
- Maintaining the relationship through frequent open and honest communication. Routine job information is an essential component of this communication. Job site visits are valuable.
- Nurturing the relationship. This requires commitment, trust, communication, timely reporting, and teamwork.

Sureties want more than a contractor that can build a project. They want a sound business partner that is rational, committed and honest, that runs a successful construction company – a company that will continue to grow and be profitable.

Disclaimer: This article is written from an insurance and surety perspective, and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.

Lead and Your Construction Business

Information Courtesy of the Environmental Protection Agency

By now, you have probably had numerous contractors asking questions about the recent EPA Lead Renovation, Repair and Painting Rule (RRP rule). EPA is also launching a consumer awareness campaign that will have the general public asking even more questions about lead paint.

So what can you do? You can be ready by downloading the informative Consumer Face Sheet at EPA's website epa.gov/getleadsafe. You'll also find print ads, flyers and bill stuffers you can distribute to your members and employees affected by this rule.

Here's the bottom line on the EPA Lead RRP rule:

- Any contractor who disturbs more than six square feet of lead-based paint after October 1, 2010, must be Lead-Safe Certified. Those who aren't could face tens of thousands of dollars in fines per violation.
- The new rule covers pre-1978 homes, apartments, schools, day care centers and other child-occupied facilities.
- Lead paint poisoning affects over one million children today. Exposure to harmful lead dust can cause irreversible damage including learning disabilities, hearing loss, speech delays, behavioral issues and lowered IQs. It can also affect adults.
- Research shows that dust spread during renovations is a key cause of many cases of lead poisoning.

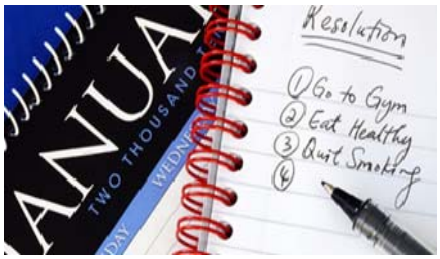
Help do your part by downloading the Consumer Fact Sheet at epa.gov/getleadsafe and share this important information.

Articles courtesy of Cavignac & Associates Employee Benefits Department

LIVE WELL, WORK WELL

Get a Head Start on Your New Year's Resolution

Yes, it's only December, but that doesn't mean you can't get an early start on your New Year's resolution. If you start implementing some good habits now, it will be much easier for you to maintain them when January rolls around. Here are some good starting points for resolutions:



- Remove one bad item from your diet entirely. For example, if you drink a lot of soda, try to give it up for one month. Eliminating two 12-ounce cans of soda per day from your diet cuts about 300 calories from your diet each day.
- Get more active. Start by trying to exercise for 30 minutes, at least three times a week. Crunched for time? Even walking or cleaning your house for 30 minutes can have a positive impact on your health.
- Get more sleep. Most people do not get the recommended amount of sleep. Shoot for at least seven, preferably nine, hours of sleep a night.

Stress-Free Holiday Budgeting

With proper budgeting and a few smart shopping ideas, it is possible to find the perfect gift for everyone on your list and stay within your budget. These tips will help you stick to your spending plan and minimize your holiday financial stress:

- Make a list and check it twice: Does everyone on your list need to be there this year? A simple phone call, holiday card or homemade treat can feel just as special as a store-bought gift.
- Set limits: Write down a maximum dollar amount for each person on your list and stick to this limit.
- Be creative: Do you enjoy baking or crafts? Giving homemade gifts can add a personal touch and creating them can be a fun holiday activity for the whole family.

Community Bulletin Board

"Neighbors helping neighbors in San Diego"

Monarch Schools

- Web Site

San Diego Humane Society and SPCA

- Web Site

Downtown YMCA

500 West Broadway, Ste. B, San Diego 92101 619-232-7451

- Web Site
- Questions? Contact **Alicia Gettys** by phone at **619-232-7451** or e-mail at **agettys@ymca.org**

SDAF San Diego Architectural Foundation

- Web Site
- Questions? E-mail **info@SDArchitecture.org**

Senior Community Centers

Mission:
To provide quality and compassionate services for the survival, health and independence of seniors living in poverty

- Web Site

San Diego Police Foundation

The San Diego Police Foundation supports the men and women who "protect and serve" by raising community awareness of important unbudgeted or "discretionary" needs that will improve crime-prevention and law enforcement efficiency. The Foundation puts your tax-deductible contributions to measureable work in local communities.

- Web site
- SafetyNet
- For more information, contact **info@sdpolicefoundation.org**

Society for Design Administration

An Affiliate of the American Institute of Architects

Mission:
The Society for Design Administration advances management and administrative professionals in the A/E/C industry through education, networking and resources.

- Membership
- Web Site
- For more information, e-mail **vicepresident@sdasandiego.org**